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Meeting of the Federal Open Market Committee

September 20, 1988

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 20, 1988, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Black
Mr. Forrestal
Mr. Heller
Mr. Hoskins
Mr. Johnson
Mr. Kelley
Mr. LaWare
Mr. Parry
Ms. Seger

Messrs. Guffey, Keehn, Melzer, and Morris, Alternate
Members of the Federal Open Market Committee

Messrs. Boehne, Boykin, and Stern, Presidents of the
Federal Reserve Banks of Philadelphia, Dallas, and
Minneapolis, respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Broadbuss, Lindsey,
Siegman, Simpson, and Ms. Tschinkel,
Associate Economists

Mr. Sternlight, Manager for Domestic Operations,
System Open Market Account
Mr. Cross, Manager for Foreign Operations,
System Open Market Account

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and
Statistics, Board of Governors
Mr. Promisel, Senior Associate Director, Division of
International Finance, Board of Governors
Mr. Stockton, Assistant Director, Division of Research
and Statistics, Board of Governors
Mr. Keleher, Assistant to Governor Johnson, Office of
Board Members, Board of Governors
Mr. Wajid, Assistant to Governor Heller, Office of
Board Members, Board of Governors
Mr. Gillum, Economist, Open Market Secretariat, Division
of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Messrs. Balbach, Davis, Ms. Munnell, Messrs. Rolnick,
Rosenblum, and Scheld, Senior Vice Presidents,
Federal Reserve Banks of St. Louis, Kansas City,
Boston, Minneapolis, Dallas, and Chicago,
respectively

Messrs. Akhtar, Meyer, and Sniderman, Vice Presidents,
Federal Reserve Banks of New York, Philadelphia,
and Cleveland, respectively

Mr. Vangel, Assistant Vice President,
Federal Reserve Bank of New York

Transcript of Federal Open Market Committee Meeting
of September 20, 1988

CHAIRMAN GREENSPAN. Can we have a motion to approve the minutes of August 16th?

SPEAKER(?). I'll move it.

CHAIRMAN GREENSPAN. Is there a second?

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection, the minutes are approved. Similarly, we need a motion to accept the Report of Examination of the System Open Market Account, which was distributed in late August.

VICE CHAIRMAN CORRIGAN. Move it.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Cross, will you bring us up to date on operations in foreign currency markets?

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Any questions for Mr. Cross? If not, do I have a motion to approve his operations during the month since the August 16th meeting?

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Is there a second?

MR. JOHNSON. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Sternlight, would you bring us up to date on domestic open market operations?

MR. STERNLIGHT. Yes, thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Any questions for Mr. Sternlight? If not, I'll entertain a motion for approval of the actions of the Desk since August the 16th.

SPEAKER(?). So moved.

CHAIRMAN GREENSPAN. Without objection. Now we'll go to the economic situation, Mr. Prell.

MR. PRELL. Thank you. [Statement--see Appendix.]

MR. PRELL. I might note that this morning the Commerce Department released revised second-quarter GNP figures where the second-quarter growth rate was revised down from 3.3 to 3.0 percent.

That would still leave, after the drought effects, growth in the nonfarm economy in excess of 3-1/2 percent in the first half.

CHAIRMAN GREENSPAN. Thank you. Questions for Mr. Prell?

MR. BLACK. Mike, could you give us some of the details of the revision in GNP, including the deflator and the fixed-weight deflator.

MR. PRELL. Sure. Both the deflator and the fixed-weight price index were revised upward. The fixed-weight price measure was raised from a 4.7 percent to a 5.0 percent increase. The deflator largely reflected this; it was up from 5.1 to 5.5 percent. It's a little bit of an unfavorable mix shift.

CHAIRMAN GREENSPAN. What was the composition of the change in the fixed-weight? What additional information did they have?

MR. STOCKTON. It appears that most of the upward revision of the fixed-weight index occurred in the service category. That's an area where, in addition to using some information from the CPI, they also bring to bear additional information. For instance, they use wage rates of hospital workers to help estimate the medical care costs and information they're getting from the banking industry to estimate banking margins. So they do get some additional information in addition to the CPI.

CHAIRMAN GREENSPAN. That's a rather large increase for a second shot at the fixed-weight.

MR. PRELL. We don't have the full detail yet, and we haven't had a chance to talk to people about enough of the details. We're flying a bit blind at this point.

MR. BLACK. Do you know which components of GNP were revised down?

MR. PRELL. Yes. There were, of course, small revisions in a number of categories. The most dramatic revision in growth rate was in nonresidential structures. As we had noted in the Greenbook, the construction-put-in-place showed a substantial revision in June. So this isn't a shock. There was a modest upward revision in consumer spending. There was a small change in net exports. There were just small changes sprinkled around.

CHAIRMAN GREENSPAN. Mr. Parry.

MR. PARRY. I have a question about your forecast of net exports. There's a very substantial improvement in the net exports over the period. I get the impression that if one were just to look at the model forecast, assuming a relatively moderate decline in the value of the dollar, that you wouldn't get that significant an improvement. Am I correct in assuming that your forecast has a large judgmental component; and if so, is that sort of the opposite of what we saw when the dollar was going down? When the dollar was going down, the model predicted a more quick response in terms of net exports. Now that the dollar has gone up, are we assuming that has a

delayed response as well--in terms of slowing the improvement in net exports?

MR. TRUMAN. There's only two things to say about the model over the forecast period. One is that in talking about trade these days, we have found that you have to sort out the effects of business machinery on both the import and export sides. On the export side in the model, we may be slightly more--well, actually, not even that much more--optimistic than the models we use. Taking the second quarter as a base, we have improvement of \$40 billion in the volume of non-agricultural, non-business machine exports; and the model that we use has just improvement of \$36 billion. So, the order of magnitude is quite small on that side and I think it's roughly the same on the non-petroleum volume. It's about the same in terms of the changes that we produce. The other thing that's going on is that, starting from the second quarter of 1989, you get improvement on the volume side in the agricultural exports--which gives you a boost in this period when we total these figures. That's a special factor.

MR. PARRY. So you don't know.

MR. TRUMAN. We don't have a lot of optimism. In part, the optimism that we have is built into the level that has been associated with the first half of this year. We have to acknowledge that perhaps the first half has performed better than the models would produce for the year. And we had chosen not to take [unintelligible]. In that sense you have maybe more of a catch up with the [unintelligible] the first half of the year. To say one more thing: On the import side, we have increasingly tried to relate business machinery, which is quantitatively very important in GNP terms, to the forecast for business fixed investment in general. So that's driven in large part by that forecast and our assessment of a large portion of that [unintelligible] is sort of how the world markets for computers seem to be developing. [unintelligible]

MR. PARRY. Yes, thank you.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. Let me just follow up on Bob's questions. Since the last forecast session, many of the major economies in the world have had upward revisions in their real growth forecast for the rest of this year and also for 1989. I'm wondering, how do you factor that into your export numbers? Or did you?

MR. TRUMAN. Well, we didn't. The official forecasts have been revised up; they lagged way behind the data. We have not changed our forecast. In fact, this morning the Japanese GNP number came out for the second quarter, which shows a decline of 3.9 percent at an annual rate. That is largely statistical. We had built in a decline of 2 percent at an annual rate. So that's a [unintelligible]. Our sense is that, if anything--although we have about the same outlook over the six quarters of the forecast--it is at a materially subdued rate relative to what we've seen. And that's largely because we have a tighter monetary policy picture for most of these countries, and most of the countries are moving in the direction of fiscal restraint. Germany, the UK, and Japan are basically moving in the direction of

fiscal restraint over the forecast period. And then you have that tightening monetary policy move.

MR. HOSKINS. Mike, could you refresh me on what the interest rate increase is--the assumption based on your forecast.

MR. PRELL. We still have the federal funds rate rising to something in the vicinity of 9-1/2 percent by next spring. We have the long Treasury bond rate moving a bit above 10 percent.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. I have a question for Mr. Truman. I note that you're expecting a better than \$25 billion deterioration in net investment income this year as compared to last year. But you show no further decline in 1989.

MR. TRUMAN. That's largely a function of the capital gains effects. You had net capital gains in the current accounts--I don't remember these numbers, but on the order of plus \$15 billion--last year because as the dollar declined you had a favorable valuation effect on foreign investments. And this year, with the dollar appreciation, we are estimating a loss of \$4 billion. The swing is essentially \$20 billion in capital gains for this year versus last year. And that swing is what generates the investment income. Next year, with a much milder decline of the dollar--although we have a smaller positive factor--the swing is not nearly so important. There are some other special factors this year, including the fact there has been a tax ruling on foreign investments in the United States that requires them to report them as income deferred tax liabilities. That will generate a reported increase in income this year, and that's already in the third quarter. And that shows up as an outflow last year and will reverse [unintelligible] a bit next year when you get a positive net effect. And that's the main--

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I have basically two questions. One is, if we don't get the dollar coming off from existing levels, what will that do to our ability to produce these kinds of net exports?

MR. TRUMAN. You said there were two questions.

MS. SEGER. Do you want to do them one at a time or do you want to do several?

MR. TRUMAN. The decline in the dollar is fairly gradual over the course of 1989. There's very little effect--essentially zero--in terms of the forecast of the real economy coming from that factor. It will begin to have an effect as you go off into 1990. Even the forecast of the dollar that we have using conventional models. You can have essentially an improvement in the trade balance falling out as you go into early 1990 if you just stop the exchange rate where it would be in the fourth quarter of 1989. If you stopped it where it is today, we would fall out earlier. That's something in the trade balance of around \$100 billion, depending on what happens to growth differentials--if things turn around and begin to deteriorate, or if our growth is approximately the same as that of the rest of the

industrial world. But the forecast itself is not heavily dependent in this time horizon on the course of the dollar.

MS. SEGER. Some business people are concerned about their ability to be competitive at existing levels, but maybe that's not a predominant view. My second question is one involving a statement in the Greenbook that staff continue to believe that additional pressure in financial markets would be required to slow the expansion, etc. And I guess this goes to Mike: Do you think you've seen the full impact of the tightening moves that we've had to date?

MR. PRELL. No, but our thought is that even after we have absorbed those, that we will not open up enough slack, so to speak, or reduce the pressures on the economy enough, to relieve the inflationary pressures. Therefore, we need to hold growth below potential for a period of time. What we have in our forecast is a very slight shortfall of actual growth from potential and very slight easing pressures on resources. And we think that, given the underlying tendencies in the economy, we are going to need a bit more restraint to keep things under control over the last two or three quarters of 1989.

MS. SEGER. Thank you.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes, Mike, I'd like a follow-up question to Governor Seger's questions. Apparently, you have an optimum growth rate in mind, let's say, over the next four quarters. What would that optimum growth rate be?

MR. PRELL. I don't know that we have an optimum growth rate. Basically, we sense that the pressures on resources are too great at this point to hold the inflation rate down to recent levels. And we feel some easing [of those pressures] is necessary. We believe the trend of real output growth is somewhere around 2-1/2 percent. Therefore, we believe that we've got to grow something under that in order to ease those pressures. We recognize the uncertainties about where the natural rate of unemployment is, if that's the operative concept. We recognize that the composition of activity can make a difference of-- This is a rough judgment, ultimately; I don't want to get too precise about it, but basically we think we need some additional restraint to get the economy below potential, and we believe that that probably is necessary.

MR. ANGELL. But, Mike, precision is helpful in communication. I can take the time to pry the number out of you by asking you a series of questions, but it would save some time if you'd simply tell us.

MR. PRELL. I think I cited a number of 2-1/2 percent, Governor Angell, as what we believed potential GNP growth is. Therefore, it depends how fast you want to get the inflation rate down. If--

MR. ANGELL. What would you think would be the optimum adjustment process? I mean, do you like 1-1/2 percent better than 2-1/2 percent?

MR. PRELL. Well, you're asking me to make a policy judgment, a subjective judgment about the short-run costs and benefits of a policy you have in mind. What we have tried to make is a positive statement: That if you want to avert some acceleration of inflation, we need to reduce the pressures on resources. The more that is done, the greater the chances are you will see no acceleration at all in the underlying inflation rate next year and that you will be able to tip it down noticeably in 1990. I think it will take more than we have built in here to make a decided move towards restoring a disinflationary trend by 1990.

MR. ANGELL. But, Mike, there's a policy assumption involved in the interest rate forecast and I am just not sure whether you'd prefer 1-1/2 percent real GNP growth or a 1/2 percent GNP growth or a negative 1/2 percent. I'd like to have some better understanding of what you think it would take in order to get this best adjustment.

MR. PRELL. Again, I don't feel I'm in a position to declare the best adjustment. I suspect, going around the table here, the policymakers would have some different views about the risks they would want to take and how rapidly they would want to move to bring down the inflation rate. If I were to aim at the kind of inflation trajectory that you've outlined--declines of 1 percent a year in the inflation rate--I would suggest that you would need a substantially greater tightening. You would need to bring growth down substantially from what we have in order to get back on that track. I don't think we're on that track now, and I think you'd need substantially greater restraint--probably close to or even into recessionary conditions--in order by 1990 to have an inflation trend down to 3 percent at an annual rate.

MR. ANGELL. Thank you. The last statement finally answered the question.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. Mike, what did you say your federal funds rate forecast was? Lee asked, and I forgot. Did you say 9-1/2 percent?

MR. PRELL. We're looking for around 9-1/2 percent. Again, I don't want to be too precise.

MR. JOHNSON. Yes, I know.

MR. PRELL. A significant increase from where we are.

MR. JOHNSON. And you're saying about a proportional move up in the long-run rate to 10 percent?

MR. PRELL. Just about.

MR. JOHNSON. The only question I have about that is that we haven't seen that kind of trend with our moves on the funds rate this year. We've had a 1-1/2 percentage point increase in the funds rate and actually a sharp flattening of the yield curve. Long rates stayed about where they were, maybe going up some, but much less than proportionally. I think the yield curve has flattened from about

2-1/2 percentage points down to less than 1 percentage point. What if that trend continues? What would the forecast say if the move to 9-1/2 percent on the funds rate was not accompanied by a proportional move in the long bond? What kind of differential effects would that have?

MR. PRELL. As you know, some of this extreme flattening is a very recent phenomenon. Earlier in the year, you were getting more substantial increases in long rates as short rates rose. I guess underlying this projection, at least in my mind, is a sense that the markets may have overdone things recently and that part of this may be the lack of long bond authority and unusual tightness in the long end of the market at this point. But we do have what would be a fairly substantial rise in long rates along with the short rate increases in this forecast, partly on the presumption that the market will be surprised to some degree by what it takes in order to damp inflationary pressures. They would come around more to our view; there's a strict internal consistency in these forecasts.

MR. JOHNSON. No, that's okay.

MR. PRELL. If the rates don't rise--, they might not rise as much for a number of reasons. One could be a change in inflationary expectations. We may have had some of that recently, where the apparent willingness of the Fed to move earlier than some would have thought may have helped to hold down long-range inflation expectations. To the extent that that's going on, you're perhaps not getting a significant real rate effect and thus the damping influence on demand. If events transpire that cause real rates not to rise as much as we would anticipate in this forecast, then we might have a different outcome where investment demand may be sustained a bit more than we have [in the forecast]. There are innumerable scenarios that one could draw where the movement in long rates would have different implications.

MR. JOHNSON. I understand. What I'm saying is, let's assume it's inflationary expectations being adjusted, and that's why the long rates haven't gone up. Say that continues to be the case, but the funds rate goes up to 9-1/2 percent without much change in the long bond due to improvement in inflationary expectations or something like that. What would be the differential impacts of that?

MR. PRELL. You're saying that if the flattening occurs entirely because of reduced inflation expectations--

MR. JOHNSON. Okay, entirely, let's say, to debate the extreme.

MR. PRELL. It would depend in the short run in part on whether it was a change in the long-run perception of what inflationary trends would be and in part on whether it was a reflection of a sense that the economy might be headed toward recession. Clearly, in other historical experience we've seen a marked flattening of the yield curve just before downturns in the economy. If we were to move up short rates as much as we're talking about here and the long rate didn't rise at all--that would be a very steep downward slope. And I suspect it would only occur in

circumstances where people would perceive that there was a significant likelihood of a near-term weakening in the economy.

MR. JOHNSON. Your view is, though, that these expectations will be revised in the near future and that the long bond will move back up?

MR. PRELL. That's basically what we're assuming. It's very difficult to psych out the market at this point. One can come up with a number of alternative hypotheses about why the market has behaved in just the way it has recently--in interpreting recent news and so on. Another factor is the dollar situation, in terms of our longer-run external position and what we think ultimately we need to correct that. That's probably a factor that's going to be less favorable as we move along in the projection period. And, as I suggested, we're presuming that the market will perceive that a greater degree of restraint is necessary to rein in inflationary pressures than perhaps it currently is. They will come around to [unintelligible].

MR. JOHNSON. And if that's the case, then the long bond would be surprised into further upward moves.

MR. PRELL. Right.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Mike, you've made I think a rather persuasive case both in your written comments and your oral comments this morning that we will need some additional restraint to hold aggregate demand to the level that's more consistent with reducing inflationary pressures. I wonder if I could get you to put yourself on the other side of that question. I wonder if you could help a slow mind this morning and articulate the case that maybe we won't need the kind of restraint that you're talking about to get the job done. In other words, I wonder if you could admit to where the cracks might be in your argument and the things that might happen that would say that while we might need a touch more restraint, maybe we've done much of the job that we need to do.

MR. PRELL. I hope I wasn't too persuasive because there is a range of uncertainty about our forecast. For example, one of those areas of uncertainty obviously is the sensitivity of investment demand to what has already occurred in interest rate movements and the dollar. There's been some perception already that the future competitiveness of some U.S. industry will be less than people thought previously; perhaps the momentum of investment might not be as strong as we have in this forecast. Fiscal policy we have interpreted as providing a degree of restraint on aggregate demand. That is always difficult to interpret and it's conceivable that our underlying policy-action assumptions could turn out to be wrong. And we could have a greater degree of restraint being applied, damping activity more than [unintelligible]. Consumer spending has fairly consistently surprised us in this expansion by its strength, and as this has occurred, consumer debt levels have risen. We've outlined for you what we think the cash flow consequences are of rising rates on households. We feel this isn't a big problem, but again one would have to admit the possibility of some surprise there. The oil price situation is something imponderable and that's a very difficult

situation to sort out, because it has underlying aggregate demand effects if we were to get a change in the price from our assumption. I feel reasonably comfortable with the inventory situation, but there too, there may be some pockets in the retail level that could exert more of a drag on output in coming months than we have [assumed]. But I don't see that as a very great problem. So, I think there are any number of areas across the economy where conceivably things might turn out weaker than we have.

MR. BOEHNE. Thank you.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mike, if you would for just a second speculate on the other side of the suggested policy recommendation for taking federal funds up to 9-1/2 and 10 percent--the possibility that that might induce a recession somewhere along the line. What would be the implications of a recession let's say in late 1989 or early 1990 if you began to see the federal deficit burgeoning and so forth? What would be the broad brush of a scenario of a recession, given the larger picture of where we are on the deficit and the new president in place trying to get new policies established and so forth?

MR. PRELL. Well, I'm not sure that that recession would appear soon enough to greatly affect the discussions about the 1990 budget. But it's conceivable that, in your hypothesis, the picture could change and then one has to make a political judgment. There are many people, obviously, who would question the ability of the Congress to institute significant further deficit reduction measures if the economy appeared to be weakening. And the actual budget deficit in those circumstances could become very large in 1990, which in effect would exacerbate the long-run problem by adding further to the level of debt. So, it's a pretty dicey situation. I think it's clear that they will have an easier time putting together a budgetary package that makes substantial ongoing progress in reducing the deficit in an environment where the economic outlook appears to be reasonably satisfactory.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Mike, a few minutes ago you alluded to inventories as a possibility of adding a little bit to the downside. But I have the impression that your inventory path is really pretty conservative. Is that a fair characterization?

MR. PRELL. Basically, if we strip away farm and strip away autos, which are in good shape now--though there may be some accumulation over the remainder of the year. But I think that's a sort of a separable situation. Outside of that area, we're looking for a bit faster accumulation than we saw in the spring over the remainder of this year and then some slight tapering off. It's not a dynamic factor in this projection. And as the Chairman has pointed out, in an environment where business activity is fairly robust and capacity is getting tighter and prices are rising fairly rapidly for materials and so on, it's not inconceivable that at some point manufacturers will become more aggressive than we've put into this forecast. We have manufacturers increasing their inventories over the coming months; but there could be an outside risk, as I noted in my

comments, that if things got out of hand on that score it could add perhaps to greater near-term strength in the economy. But it would set us up perhaps for more of a shakeout later on in 1989.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Mike, I'm having difficulty understanding the consistency between your interest rate forecast and the forecast for further downward pressure on the dollar. Help me with that one.

MR. TRUMAN. Maybe I ought to do that. The forecast for the dollar is largely driven by the view that ultimately you have to have substantially smaller trade and current account deficits than we have now. The exchange rate adjustment will be part of what brings that about. We don't have any strong view about when we're going to get it, but it would be over the next five years, say. So in building the forecast we have tended to put in a moderate decline in the dollar as a background factor, which does not have a big role in the short run but it is the direction of where we think the pressure is going to be, as I said in my answer to the question from Governor Seger. In producing the forecast we tried to, in some sense, trim that longer-term view by what our assumptions about monetary policy here and others [unintelligible]. Over the past several meetings of the Committee we have tended to adjust up our forecast of the dollar; we have less of a decline in the dollar cumulatively over the period for basically two reasons. One is that the trade performance has been better than we--and I think a lot of people--expected. Therefore, in some sense, the amount of adjustment you need in this process is less. So you don't have to build much into the medium-term framework. We have moved the dollar up because the presumed stance of monetary policy has been somewhat tighter. But over this immediate horizon, we have the dollar flat, essentially, over the balance of this year. That is associated with a view that there's a perception of policy as being tighter. But as we move into 1989, there inevitably will be some slowing in the pace of current account adjustments from what we've had over the past three or four quarters, and we would expect to get some reemerging pressures on the dollar despite the increase in the interest rates that we have had. We have tried in a very crude way to talk about what it would take to stabilize the dollar, and it is a difficult question to answer convincingly--as I explained in the first part of my answer--if you view the dollar's course as being driven by medium-term factors. But the answer comes out somewhat like the answer to Governor Angell's question: That you need more than monetary restraint in the short run [unintelligible] the dollar.

MR. LAWARE. Thank you.

CHAIRMAN GREENSPAN. Any further questions for Mr. Prell? If not, we've come to the general discussion where the individual members will give us definitive forecasts of the outlook.

MR. BOYKIN. Mr. Chairman, I'll lead off. As far as the Eleventh District economy is concerned, we're looking at what's happening or might happen in energy--which over the past year or so is showing a little bit of improvement and turning into more of a neutral factor for us. As far as the outlook for the economy generally, the overall mood of the people that we've talked to very recently has been

a little more positive, although it's difficult for them--or for us--to point to specifics that show that something's happening.

If we do get a sustained price for oil in the \$14 range, that would probably indicate that we have no growth at all in our District economy, whereas we currently have a forecast of sluggish growth of something around 1 percent or less for next year. We are getting reports of substantial capital investments that are planned or that are under way in petrochemicals, particularly in Houston--the upper Gulf Coast area. And they are, of course, benefiting from the lower price of oil.

We were fortunate over the last several days to have missed some of the rather devastating effects of Hurricane Gilbert. Although there were tornadoes and there was some damage, it wasn't anything close to what had been anticipated. The real estate area continues, of course, to be the biggest drag that we have. And I do have a real--as opposed to an anecdotal--comment on that. About five years ago, we had our bank property appraised in connection with a study that we were doing. The appraiser came up with a value in excess of \$30 million, which a couple of our directors--particularly our then-Chairman who was in the real estate business--felt was low. We've just had our property reappraised in connection with another study we're doing. The same professional independent appraiser group did it this time. They're telling us that our property now is worth between \$6-1/2 and \$8-1/2 million. You know, that's something else.

MR. BLACK. What did you do to it? Did you take care of that place?

MR. ANGELL. Bob, it sounds like quite a bargain, doesn't it?

MR. BOYKIN. Well, there are special factors. The key--and this is not the place to make this statement--but I'll make it anyway. What they're saying is our building is totally used up in terms of its usefulness.

CHAIRMAN GREENSPAN. Over the last five years!

MR. BOYKIN. But I thought that was very, very significant. Granted, we have special circumstances; nevertheless I have a better appreciation of what the commercial banks have been having to deal with as they get new appraisals and reappraisals. And I don't believe anybody knows what real estate is worth any more.

CHAIRMAN GREENSPAN. Well, conversion in terms of barrels of oil isn't that bad.

MR. BOYKIN. That's all I have.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Thank you, Mr. Chairman. I'm sorry I don't have a real estate study to talk about this morning. Let me turn first to the national economy. I have very little problem with the Board staff's Greenbook forecast; in fact, if we were to build in roughly the same kind of restraint that's in the Greenbook we'd be very close indeed. I think all forecasts these days are a little bit

cloudier than usual because of the statistical difficulties with the drought, so I think we need to be a little careful about forecasts generally.

I'm very happy to see the recent deceleration, although I wouldn't want to put a lot of credence in a couple of months' data. But I think the thing the markets perhaps are not focusing on is that we are still growing beyond our potential. And that is really what's guiding my thinking and my judgment at the present time. In response to Governor Johnson, there was a discussion about the yield on the 30-year bond and long-term rates generally, and it seems to me that the market may very well be underestimating the strength of the economy and thus reducing its inflationary expectations. I think there is generally a tendency among market participants and business people that I talk with to feel that a slowing economy is a slow economy. I think we've gotten used to large numbers over the past several quarters and the focus is not really on the potential of the economy. So, I not only agree with the forecast, Mr. Chairman, but I agree with the analysis of the staff that unless the economy slows appreciably, we will have to restrain growth further--take additional [steps of] monetary restraint--by the end of the year.

I don't think I need say very much about the District because not a great deal has changed since the last meeting. Growth in the Sixth District remains fairly spotty. The manufacturing tradeable goods sector is doing quite well, but the service sector--particularly in urban areas--is not doing well and is really quite sluggish. Construction is off. We used to report pretty regularly, as I said last month, that almost every state with the exception of Louisiana was doing better than the national average. That has really turned around. I think Florida now would be the only state that I would characterize as doing better than the national average. The unemployment rate in all of our states except Florida is now above those in the rest of the country. The good news part of that, I suppose, is that there's very little pressure on wages in this kind of a market. I probed a lot for that among our directors and other business people; and while you hear a little bit of concern about entry-level people and trying to attract them with higher wages, basically we're not seeing any wage pressure at all. The same thing is true generally of prices. The price increases, where they have occurred, have been kind of spotty and in industries that are really going flat out--paperboard, paper, and so on.

The good news in all of this is that Louisiana and Mississippi are doing better than they were. That's basically because of some chemical production that is now occurring in Louisiana as well as the pickup in ship building. Although they are doing better, we have to remember that they're coming from a very low base and they would still have to be characterized, I think, as negative growth areas. On the agricultural side, higher prices for some agricultural commodities are going to improve farm incomes since the crop yields were not as affected in the southeast as they were in other areas of the country. That's all I have, Mr. Chairman.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. With regard to the national economy--with some modest adjustments for the fourth quarter of this year and the first

quarter of next year due mainly to agriculture--our outlook is quite consistent with the staff forecast in the Greenbook. With regard to the District, there's really very little that's new to report. With the obvious exception of agriculture, I think the economy continues to be really very strong. But there are just a few signs of moderation--nothing pronounced. I think there are somewhat slower growth rates in a couple of parts of our economy. Retail sales, for example, were much weaker in the summer months than earlier in the spring. And construction activity is down a bit. Another example is paperboard, which of course has been so very strong; after a string of almost two years of record monthly shipments, last month's shipments were down just a bit there.

It's too early to tell if these early signs are indicative of a trend and if they're going to be sustained. It's entirely possible. I think, that the trends--particularly in some of the areas that I've mentioned--are the result of the exceptionally hot weather that we've had. Since the turn of the weather, I'm told by retailers that the flow of traffic in their stores is back up to more normal levels. So some of these things may have been very weather related.

Perhaps the lack of any significant changes could be a good thing. Anecdotally, at least, I don't sense a continuation of the upward pressures on prices that were so very evident earlier this year. I still think that the risks are very much on the side of greater inflation. But I am beginning to hear some comments about the leveling of prices for a variety of materials--or certainly that more moderate increases are taking place as opposed to the big numbers that we had earlier this year. And at least one major manufacturer that I talked to the other day is forecasting that raw material purchases next year will be level with 1988--really no increase at all.

Surprisingly, consistent with what Bob Forrestal has just said, I don't sense any deterioration on the wage front. Wage rates do not at this point seem to be accelerating. Also, there doesn't seem to be a hardening of attitudes on the part of labor. I'm told that the attitude of organized labor continues to be very constructive, given the continued progress on work-rule changes. So I think the news there continues to be pretty good. Companies are not losing ground on unit labor costs but, as a caveat on that, there are two major contracts out there that are currently reaching the final stages of negotiations. We'll just have to wait to see how those work out. Again, I think it's too early to tell whether these early signs of moderation will be sustained. But certainly they are favorable, and for now it just could be the case that things are falling into line pretty well.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Mr. Chairman, the Twelfth District economy appears to be growing at a relatively brisk pace, and I'd say that the outlook for the District generally is favorable. A very strong order book for aircraft should assure strength in the Seattle area for a couple of years. That also boosts prospects in the aircraft industry in southern California. Prospects for the growth of exports are reasonably bright for such things as agricultural products, specialty products, and also transportation and electronic equipment. Agriculture in the west appears as though it may actually be

benefiting somewhat from the drought as a result of the higher prices that more than offset the effects of very mild reductions in yields in the west. At this time, signs of weakness in the District are really quite spotty. And they're only concentrated in a few states--Alaska, Arizona, and Utah--and a very few industries as well. Residential construction is weak. Dairy and livestock are rather weak as a result of the fact that they're paying higher costs for feed. And aluminum and forest products are weak due to capacity constraints. It's rather interesting that even where you have weakness, it's in areas that are pretty much up against capacity constraints: in residential construction, for example, that's solely a result of extremely strong export demands for lumber. Weakness may intensify in the District if the very recent sharp slowing in retail advertising in California--which looks quite pervasive--is a precursor of softer retail sales.

If I may turn to the national outlook, it's my view that it's premature to conclude that the recent softening of economic statistics is indicative of a trend that will persist through 1989. Rather, it seems more likely to me that if interest rates were to remain at present levels, growth of the nonfarm economy would probably exceed the growth of potential over the entire forecast period. Thus, prospects for the underlying rate of inflation still are a concern, though obviously we're going to see actual inflation rates buffeted by many special factors. If this expectation in our forecast is correct, then it seems to me that the process of tightening probably is not over and will have to be resumed sometime soon. Thank you.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. Mr. Chairman, our forecast at the Bank is one that I think is close to the other side of Mike's coin. We do not have a significant increase in interest rates built into our forecast; we have a bit of an upward drift. But for that reason and for others, it's a forecast that ends up, on balance, with a phenomenal GNP growth rate--a percentage point and a half or so above what's in the Greenbook. And because of where we are relative to potential, a good part of that excess shows through in terms of higher inflation. Indeed, by the end of the forecast period, our forecast would have a very significantly higher inflation rate than what's in the Greenbook.

That is not a testimony to any one forecast, but I think it's very vivid testimony to how much of a razor's edge we are on, in terms of what does or does not happen in the economy. I don't have a great deal of conviction per se about any one forecast, but I must say my instincts continue to be very similar to Bob Parry's. I'll just briefly share [some comments] with the Committee, Mr. Chairman, partly because this is such a very difficult period to read.

In the first two weeks of September, we talked to a couple of dozen firms to try to get a more systematic anecdotal appreciation of what's going on. Now, a systematic approach to anecdotal reports is in no way a survey for purposes of OMB or anybody else.

MS. SEGER. Can't be or you'd get in trouble.

VICE CHAIRMAN CORRIGAN. With that in mind, I'd like to touch on just a couple of the highlights. The firms that we talked to

included about a dozen or so very prominent manufacturing firms with headquarters in the Second District, some smaller manufacturing firms, and some very prominent retail firms. As of right now, what comes through is that the export sector is literally still booming. Export sales were very strong indeed, with increases in volume terms typically well into double digits. There was only one case where that was not true, and that particular firm didn't seem very concerned about it because they have a very large backlog of orders--orders that haven't even formally been booked yet for jet engines that are ultimately destined for overseas markets.

On the question of the current level of the dollar, none of the firms expressed any concern about the current level. Indeed, the impression was that even at current exchange rates, U.S. firms were quite competitive except in apparel and clothing categories. There were two small firms that did say that a yen/dollar of 140 was kind of a threshold for them. But generally speaking, there was no concern expressed in terms of current exchange rates and the ability of this strong export performance to continue. But perhaps even more interesting is that we see here for the first time, in anecdotal terms, a number of clear cases of capital goods shifting away from foreign suppliers to U.S. suppliers. I don't want to suggest that that was the universal pattern, but of the major firms, about an equal number reported that positive shifting was taking place. None said it was getting worse, with the exception of one company that was doing more sourcing from Mexico--which in some ways is a good thing, of course. In addition, quite apart from capital goods, there were also a number of firms--and we haven't heard this for a long time either--that were also reporting gains in domestic market shares in general, relative to imports. In other words, they are actually now displacing imports in the domestic marketplace. Again, the major exception to that is all of the clothing and textile firms--apparel-related things. That area is still lousy throughout, both at production and retail levels. But in other areas there are some distinct changes. In terms of domestic sales performance, with only one or two exceptions, these firms reported current trends I think that were really quite strong, often in double digits.

On the output, wage, and capacity side--again, none of this is very scientific and I don't want to put the wrong cast on it. But it's really interesting because about half of the big firms--and these are the manufacturers, of course--reported no capacity constraints to speak of or nothing they couldn't cope with. Whereas another half reported some problems--and these were typically in the areas that we would expect. When it got to the particular question of input problems, in terms of price, delivery delays, etc., again it was about half-and-half. About half did report that they were having input problems defined either as rapidly rising prices or delivery lags. Those patterns were clear in steel, plastics, computer chips, aluminum, paper, and surprisingly, in some Japanese component parts. But the other side of it is that about half of them didn't report particular problems of that nature.

On the labor question--and this is very interesting--the responses broke almost straight down the line based on size. The large firms did not report any particular problems in terms of labor shortages; the small firms did. The same was more or less true in terms of wages in general. The overall impression that I get, not

just from this but from listening to our directors and others, is that there is some upward movement on the wage side but it's not significant yet. That's defined in terms of maybe a 1/2 percentage point type of thing. But the conclusion that I draw from all this impressionistic data is consistent or compatible at least with my own thoughts and instincts--that the risks are rather asymmetric in the direction of greater pressures on domestic output and resources, at least over the near term. On the other hand, it may also be consistent with the view that while the inflation genie isn't perhaps out of the bottle, it's by no means clear that the cork is firmly in place.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. The most intriguing information I've had since the last meeting didn't come from an economist or businessman but from a psychiatrist who happened to be sitting next to me on an airplane coming back from Boston. He was writing madly and I could see the word depression, so I thought he was one of the crackpots who writes the doom-and-gloom books about the end of the economic world. After a few minutes we got to talking, and I discovered that he is a psychiatrist specializing in depression. But the useful information to me was that as he counsels people, one of the first things he asks them is for information about their spending habits, particularly the spending that they do using little pieces of plastic. And what he's discovered is that this is one of the early signs of depression--that people go out on these big spending sprees. They buy cars--no, seriously--that they can't afford.

CHAIRMAN GREENSPAN. I know; I've done that!

MS. SEGER. I'm not smart enough to make this up. They buy cars they can't afford, do all this spending, and run their cards right up to the limits--and this is just before they go over the edge. So we decided that based on what he saw and what I had seen in the statistics that there are a lot of psychos running around.

MR. STERN. Another problem for the Federal Reserve.

MR. BLACK. Another problem for him; he can [profit?] from that.

MS. SEGER. Yes, that's right, he's doing okay. In that connection, though, anyone I speak with other than him suggests that consumers as a whole aren't on a big spending spree. So I guess my view of the economy is a little less optimistic than the staff's.

Also, on the housing side, some of the realtors I've spoken with suggest, first of all, that the recent increases in mortgage rates haven't all been felt; and, secondly, that consumers are beginning to react to the high prices on new homes. Also, in certain parts of the country, like Mr. Parry's enlightened California, there are these tremendous restrictions on growth; and it's very difficult to get lots on which to build houses despite the whining about the housing shortages. So I think that our forecast on housing starts might be a touch high.

Finally, as I think I hinted in my discussion with Mike Prell and Ted Truman, I'm a little less certain that we're going to get the export improvement that we are forecasting. I would certainly like to see it because, while certainly some companies are still competitive at existing exchange rates and in [scenarios] that involve a slightly cheaper dollar, I don't think everybody is. And that concerns me. So those are the three areas where I guess I differ from the staff. Thank you.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I think every point I wanted to make has been made by someone--but some by one person and some by another. Let me just summarize briefly. We agree very closely with what the staff has suggested in the Greenbook. We see the same signs of moderation, partly because of the employment figures and other national figures, and also because of the grass-roots reports that we've getting from our directors, particularly in textiles and furniture.

But I'm glad to see this, because I thought the economy was growing way, way too fast and the risks were all on the upside. This suggests that maybe they're less on the upside now than they were before. But like most of those who have spoken, I still think that the risks definitely are skewed more towards the upside and that there's a danger that the economy might overheat. These figures showing moderation have been around for only a month or two at most, and apart from housing, there are no real large parts of the GNP accounts or significant sectors that show any signs of a great or sustained weakness.

And then, if you look at the figures in section II of the Greenbook, they show that there is some upward pressure on both wages and prices. Mike has just reported that the figures on the implicit price deflator and the fixed-weight deflator for the second quarter were worse than we thought they were, based on the initial reports. So in short, while I feel a little bit better than I did before, because there are some signs of slowing, I don't think we're out of the woods yet. And I would think that the staff's prognostication that somewhere down the line we'll need to tighten further is probably still right, although now might not be the time to do that.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. There's very little new to report on the District economy. I'll try to dispense with that very quickly. As I've commented before, most of the District economy is and remains very strong. The obvious exception is the areas affected adversely by the drought; otherwise, the economy in the District is in good shape.

As far as the national outlook is concerned, I find myself in substantial agreement with the Greenbook forecast. I don't know how much of a further rise in interest rates might be required to stem building inflationary pressures, perhaps not very much, but I think the Greenbook does appropriately identify where the risks are.

As I look at the latest statistics, I think they do suggest some slowing in the pace of expansion in the last month or two--a

slowing that, as several people have already commented, is welcomed, in my judgment. But I find that there's maybe a little tendency to exaggerate this. Even though I wouldn't try to construe the August labor market report as very strong, it's still a 200,000 increase in payroll employment--2-1/2 million workers at an annual rate--which is not a trivial increase in employment at all, especially given the tightness in labor markets that already exists. And, as I already suggested, inventory/sales ratios look, if anything, on the low side to me. So I think we may see more strength, at least in the near term, coming out of inventories than the Greenbook forecast anticipates.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. The region continues as it has been: It's operating at high levels, although there is some moderation; labor markets are very tight; and, wage rates are higher than the nation as a whole.

As far as the national economy, I subscribe to the view that the economy is moderating, but that more moderation is needed and additional restraint is probably also needed. While the risks are on the side of too much demand, I think we need at this point to keep a very open mind and shouldn't rush to judgment on it for the reasons that were articulated nicely by Mike Prell. I'd like to watch the economy closely and be prepared to tighten if necessary. But I wouldn't rush into it at the moment, just because I have enough doubts to think that a little patience is in order.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Mr. Chairman, we in Boston agree very strongly with the staff's long-term conviction that the economy is so strong--its strength stemming from net exports and capital goods--that the job of the Federal Reserve would be to try to keep this economy from going beyond capacity levels and generating a new inflationary cycle. And we agree that substantial increases in interest rates are likely to be required to produce that.

We're seeing a little evidence of a slowdown recently, but this is the kind of flow that you often get in a very strong economy. I don't think we ought to get it in our minds that we've reached a level of growth which from now on is going to be compatible with price stability. I think it's a very short-term phenomenon we're talking about. And I think our financial markets have been impacted in the last couple of months by a very special factor--a nonsustainable special factor--which is that private foreign capital inflows have been coming into this country at rates substantially in excess of the amount of our foreign account deficit. Of course, the counterpart of that is very large sales on the part of central banks, including ourselves. This I think has greatly strengthened our bond market; but it's not a factor that we can count on being sustained for very long. We've seen foreign exchange markets in the past couple of years turn on a dime. And I suspect that sometime in the next few months the appetite of private foreign investors for U.S. assets is not going to continue to grow at the present rate. And when that happens, you're going to see many long-term bonds go up by 50 basis points, and

perhaps more, overnight. I think we're living in a special financial world here which is not sustainable.

Could I comment about the meeting schedule for next year since I can do so in an objective manner since I won't be here? You know we--

CHAIRMAN GREENSPAN. In a way in which you will choose now to comment.

MR. MORRIS. We set up this eight-meeting schedule at the time we went to targeting the monetary aggregates. And the idea was that, since we're controlling M1 and presumably not paying attention to anything else, why do we have to meet every month? It seems to me that the Committee would be well advised to go back to a once-a-month schedule because we're in an environment in which I don't feel comfortable that we're not having another meeting until November 1st. It's such a rapidly changing world that we live in that I think an eight-meeting schedule is too few. It's true that we can handle problems in conference calls, but that doesn't quite substitute, in my mind, for the discipline of gathering around this table. I know the staff won't like it because it increases their work load, and a lot of the presidents won't like it because of travel requirements. But I don't think those considerations should be paramount. And I would strongly advise you to at least think about going back to the once-a-month schedule because it seems to me that the volatility of the world we live in isn't well suited to this Committee meeting every five or six weeks.

As far as the New England economy is concerned, we're continuing to grow at about half the rate of the national economy, simply because of the shortage of labor. The only state in New England which is growing as fast as the national economy is Maine, which has a very high unemployment rate of 4 percent. And it's the only surplus labor area in New England, so manufacturing industries are tending to push farther and farther north into Maine and threaten our little enclave at Lewiston, Maine. That's a very low-wage RCPC; it has the lowest unit labor costs of any check processing center in the country, and my successor may not have that distinction for very much longer.

VICE CHAIRMAN CORRIGAN. I think you can tranship them to Dallas.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I want to make a couple of comments on projections based on a money-driven model and just what that looks like. Essentially, I'd say the projections are very similar to those of the Board's staff. There are some differences between the second half of this year and next year, but I would characterize the pattern as one in which inflationary pressures are contained, but not significantly reduced, over that 18-month period. The projections I'm talking about are based on an assumption of 4 to 6 percent M1 growth. And I guess the conclusion that I reached from looking at that--and obviously, this is the model output and then, just as the Board staff does, some subjective judgments are made--was that I'd be much more concerned about, say, money growth in June and July of 9 percent, than

I would be about August of less than 1 percent. I think the general pattern is such that the same conclusion comes out in this sort of model--that the risks are more on the upside than the downside. As far as the District goes, the report is essentially the same as last month. We're still showing weakness relative to the rest of the economy and in some areas, particularly in industries like textiles and apparel, there are employment declines.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. With respect to the Tenth District, there is not a great change from last time. To summarize, we are still trailing the growth rate of the national economy. But in all areas, including energy and agriculture, there is some improvement--to be sure, improvement from a very low base. Manufacturing is doing very well; retail sales have been holding up but not very vigorous. By and large, the Tenth District is continuing on a trend to recovery, but a bit slower than the national rate.

With regard to the national economy and the projection contained in the Greenbook, we would be very close to that except that the pattern we have is a bit different. If I understand the Greenbook forecast, the drought effect has largely run its course by the end of the year, whereas we would find the effect to be fairly even in each of the four quarters from the second quarter of 1988 to the second quarter of 1989. Notwithstanding that minor difference, it still seems to me that we are projecting a very vigorous growth well into 1989. And, given the comments around the table and what we hear in the Tenth District with respect to wage and price increases not really showing up yet, it is still a matter of major concern that, on the national level, we're putting considerable pressure on our resources. I guess my view is that there is going to have to be some greater restraint in the future in order to get the kind of pattern over the longer term that we'd like to have.

I would also like to add, if I may, that I happen to agree with Frank Morris--as painful as it is personally because of the travel--that going back to a monthly meeting schedule makes a lot of sense, given the way we're operating at the moment.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. The District overall remains pretty strong, particularly in manufacturing. We have some slow delivery times in particular industries, and we have some price increases coming across, but nothing that startling at this point, particularly in the capital goods area. Wage demands on the manufacturing side have remained moderate, but we're concerned that because of the strength in the service wage component--they're in the same labor markets--that in fact, they'll begin influencing each other and then we'll see sharper wage increases across the board than we're currently seeing. Retail sales ex-autos have been flat and construction has been rather lackluster. As you know well, our directors have felt very strongly about the strength of the economy, except that at the last go-around they were not quite as adamant, as you probably noticed; I saw some deterioration in their concerns about inflation. Nevertheless, there's still great strength in the District.

As far as the national economic outlook, I guess I really don't have much reason to disagree with Mike's projections. However, if I were to estimate an error on it, I would say the error is probably going to be on the upside in terms of strength and inflationary pressures rather than on the downside. We've seen the inflation rate move up a 1/2 percent or so each year. And, as you know, that is the wrong direction from my perspective. I think we ought to gear policy to that long-term objective, which implies we'd probably have to face more tightening--perhaps more than the staff has in place.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. I'm very pleased with the present state of monetary policy and conditions in the economy. That doesn't mean I like the 4 percent rate of inflation. I just didn't believe that we could make the exchange rate adjustments that were so necessary to make--[along with] the rebound of oil prices from those lows and some rebound in wage rates from what I would call somewhat unsustainably low nominal rates--without having some temporary bounceback in the rate of inflation. I have no reason to think that the staff's real economy forecast is not within the range of that which is likely. I would tend probably to have a slightly higher net export figure, Ted--closer to what you had in the June Greenbook than those that you have in today--but there's not enough there to argue much about. I think if anything is different, consumer spending might be slightly softer, but it's very difficult to predict.

The pleasing aspect of policy at this point in September 1988 is that, as far as I can see, we've returned the growth of the monetary aggregates to the pace that was occurring in 1987--and I thought the rate we had in 1987 was appropriate to provide a soft landing for the dollar. And it's very encouraging to me to see that, after the monetary aggregates responded to the somewhat easier stance we maintained during the fall and winter, the aggregates have responded the way they have to our attempts to be serious about not letting M2 rise above the top of the target at the first of the year, even though we had a somewhat distorted base level. And now it looks as if M2 is going to end the year in the fourth quarter below the midpoint and could very well be as low as 4-1/2 to 5 percent at the end of the year. Don Kohn shakes his head a little bit at that. I think we have to keep in mind the time lag between interest rate changes and response in those monetary aggregates.

In June, as you may remember, I talked a little bit about the hint of changing commodity prices, and I think I was kind of reading tea leaves at that point. But we've had further evidence that the monetary restraint in place is having an impact on commodity prices--and even though we've had, it seems to me, a peaking of commodity price rises earlier in the year, the drought gave us a kind of a double-peak effect. But the commodity price picture does look much improved. I believe that the fight against inflation is a long one and one that we must sustain over a long period of time; and I would be willing, of course, to accept very low growth rates in the monetary aggregates, but I would really suggest that zero may not be desirable.

CHAIRMAN GREENSPAN. Governor Heller.

MR.HELLER. Thank you. Let me take a little bit longer perspective on the current situation. In 1986, we had 15-1/2 percent M1 growth and almost 10 percent M2 growth and that, I think, is reflected to some extent in some inflationary bulge, which is now working its way through the economy from producer prices slowly down to consumer prices. By the way, I think that lag is exactly what the textbooks tell us it is--18 months or thereabouts, counting from the 1986 area to slightly over the middle of 1988, with some variance around it. Then, following what Governor Angell just said, in 1987 we saw a very substantial slowdown in monetary growth and I think that slowdown is starting to make itself felt in the real economy, which we are observing right now.

As I think many people pointed out, there is some moderation in the economic growth picture in the Greenbook forecast. There's more of that weakening, especially in the coming year. Personal consumption next year is forecast to be 1-1/2 percent; residential construction is negative; and there isn't one single sector which is growing above the 2-1/2 percent growth rate that was described as optimal--except for domestic investment and exports. And I think it's absolutely essential, if we worry about growth constraint, that we keep domestic investment growing at a solid rate. It is somewhat disconcerting, however, that even the growth rate in that sector is forecast to be cut in half for the coming year. So, what we're about to do here is kill the goose that lays the golden eggs. We can't talk about a growth constraint being relevant for policy when the one factor that can ease that growth constraint, which is domestic investment, is being cut and restrained. I also agree that exports have to be maintained. I'm happy to see the higher export growth rates. The current level of the dollar, I think, is entirely appropriate. We're below purchasing power parity; therefore, we do have a competitive advantage and we can make further inroads into foreign markets.

The scenario that was outlined by Mike Prell in response to Governor Kelley's questions is the really scary one--the black box, the Pandora's box, that the new President would have to face if growth falters, if we have the higher interest rates that we're talking about, and if the tax revenues are not coming in. So I see the downside risks as a very unpalatable combination of factors indeed. The upside risks I see as rather minimal, because of the items that Governor Angell has outlined already. In my view, we're seeing essentially a moving through the economy of that inflationary bulge. If you look at the beginning of that process, you'll see very positive signs--the commodity prices being maintained, the flattening of the yield curve, and also the strong dollar in international markets. All are good portents of rather subdued inflationary expectations. So, basically I like the economy the way it is running right now. I think we're exactly on the right track and I would like to do everything possible to keep it moving that way.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. I wanted to very briefly express something very similar to what Governor Heller just expressed, and I won't repeat it. I'll simply say I'm coming from the same place that he is. I had expressed before my concern about what could happen in the 1989-90 time scenario. If the black box kind of thing begins to happen and we

slide over into a recession before we have a chance to adjust further the fiscal/monetary mix and the trade/consumption mix and so forth, I'll continue to have those concerns. I have a very low level of enthusiasm for running a high risk of inducing a recession in the near future. Hopefully, we do have some slowing going on and to quote Ed Boehne from a few minutes ago, I think that this is not a time to rush to judgment. So I would prefer to watch and wait a little bit and see how things go.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I really don't want to add much to any of that. I think everything has been said. We've seen recently some signs of slowing as everyone has pointed out. That seems to have had a moderating effect in the financial markets and I don't know whether that's going to continue or not. All I know is that it looks pretty good right now and certainly doesn't lend any weight to overreacting. So I support what others have said.

CHAIRMAN GREENSPAN. Governor LaWare, do you have any comments you'd like to make?

MR. LAWARE. No.

CHAIRMAN GREENSPAN. Why don't we, then, go to relevant policy decisions.

MR. KOHN. Thank you, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Thank you. With that we'll take our usual break.

MR. ANGELL. Are there going to be questions?

CHAIRMAN GREENSPAN. I'm sorry. I thought we might do questions after the break. We can do questions now, if you like.

MR. ANGELL. Don, we have in the Bluebook, the M2 and other forecasted growth rates. What happens in 1989 quarter 1 and quarter 2 with, let's say, alternative "B" and what would happen in quarter 1, quarter 2, and maybe in quarter 3 if you put in the staff's interest rate forecast?

MR. KOHN. I can answer the second one more easily because I have a table in front of me.

MR. ANGELL. Okay, that's fine; that's the most important.

MR. KOHN. We have about 3-3/4 percent growth of M2 over the year 1989 consistent with the staff's interest rate and GNP forecast.

MR. ANGELL. 1989 over 1988?

MR. KOHN. Q4 1988 to Q4 1989.

MR. ANGELL. Okay.

MR. KOHN. And that embodies slightly lower growth rates in the first half of the year than in the second--on the order of 2-1/2 percent in the first two quarters--and that's because we've assumed that interest rates continue to rise through the first half of the year. And then things level out.

MR. ANGELL. So that means you need almost a 5 percent growth rate in the second half of the year to get 3.7?

MR. KOHN. That's correct. Now, let's suppose interest rates were flat. I don't have a direct table here, but I do have a sense from our model simulations that to those 2-1/2, 3 percent growth rates for the first half of 1989, I would probably add about 1-1/2 to 2 percent per quarter if interest rates were kept flat. So I would have more like 4 to 5 percent.

MR. ANGELL. Okay, so the 2.8 percent rate that you have for quarter 4 would tend to rebound in quarter 1.

MR. KOHN. It should.

MR. ANGELL. If we did not have other increases.

MR. KOHN. Absolutely--with the increase in interest rates through August.

MR. ANGELL. And it could rebound to 4 or 4-1/2?

MR. KOHN. Yes, in the first half; and I would expect it to rebound further in the second half as--

MR. ANGELL. Thank you. That's very helpful.

CHAIRMAN GREENSPAN. Any other questions for Mr. Kohn? If not, we'll have a recess.

[Coffee break]

CHAIRMAN GREENSPAN. Following up on Peter Sternlight's remarks about the borrowing requirements, I think that policy generally over the intermeeting period has required very little in the way of adjustment. In fact, it's very rare that the outlook seems to change so little over so short a period. One thing that worries me about the current economy is that it is vaguely reminiscent of a sag that occurred in 1976--which everyone assumed was the beginning of a decline, and it was a pause which sort of disappeared. That was a bit more in the way of a real slowdown. And I think we've got to be a little careful that we're not looking at a false dawn.

Export orders, unfilled orders are still very high. I see no evidence of any deterioration, even though there's been some slowdown in actual deliveries over the last three months. Capital goods markets remain quite strong. The order structure, appropriations, does not seem to be deteriorating. It is true that there is some marginal weakening on the edges in a lot of different areas--the textile-apparel complex, I think, being the most obvious and the most important so far as size is concerned. I think the crucial issue, which bothers me about the presumption that we would be in any way

accumulating a softening from here, is that the inventory situation has actually softened some. And I suspect that's in part the cause of some of the overheating or preceived overheating being offset. I'm a little concerned about the numbers, because whenever you get this high in operating rates, seasonal adjustments for July and August often tend to be a problem. The classic case is the steel industry, which normally shuts down for a couple of weeks as an ordinary seasonal, but in times of peak demand, such as now, it doesn't shut down. Then what you get is a seasonally adjusted sharp rise, unless somebody has the good sense to cut it. And it comes right back down. I think that's a part of the surge that appeared to be a real acceleration in June and July and an easing in August. I suspect--at least looking at the initial claims figures which I think are really relevant to this situation--that basically, the economy probably continues firm, although not as aggressive as I think some of us feared somewhat a little earlier in the summer and in the late spring. Corporate profit figures look quite good. The report this morning was showing that profits continue to move forward in a reasonably good fashion and that usually is a precursor of underlying capital investment--domestic capital investment--being supported.

So, in general, I think it is very difficult to visualize any really significant change in the outlook. I think we're neither accelerating nor decelerating. As a consequence, I must say I would feel comfortable with just taking the last directive, changing the dates and a couple of numbers, and going with it. It is essentially a no-change scenario, asymmetric towards tightness, which I think is probably right. My only suspicion is that we're not going to see anything that will require moving in a tightening direction in the intermeeting period. But I find the possibilities of easing just about as remote as I think they can get. I see no particular problem in continuing to be concerned about acceleration but I think that, unless and until we actually see the events as they emerge--until we get some evidence that this is in fact the type of pause which, frankly, I think it's likely to be--it would be premature at this stage to tighten further. Governor Angell.

MR. ANGELL. Mr. Chairman, I can certainly go with your suggestion. I, too, believe that we're more likely in the intermeeting period to need to tighten than we are to ease, but I would not take that to mean that there's not some circumstances in which we might be surprised. If there's a 60 percent chance that we would not need to make any move at all, and a 30 percent chance we might need to tighten, I think there are some circumstances that might develop--that conditions might change in an economy with certain kinds of financial bankruptcies occurring and certain kinds of uncertainties. But I can--

CHAIRMAN GREENSPAN. If you're saying 60, 30, 10, I buy that.

MR. ANGELL. Okay.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. If that's in the form of a motion, I certainly would second it, particularly with the asymmetric language. I would point out, though, that I really do doubt that we're going to be lucky enough to get through more than a meeting or two without further

tightening. I think there are pressures on the underlying rate of inflation that are likely to intensify. And I think that some of the potentially favorable developments associated with the price of oil and the rising dollar--as far as inflation is concerned--could easily be reversed. At this time, given the uncertainties, it seems to me that alternative "B" is probably the appropriate path. But given my concerns, I would very much favor the asymmetric language that was incorporated in the previous directive.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Second the Chairman's suggestion.

MR. PARRY. Third.

SPEAKER(?). Third.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, as I had tried to suggest in my earlier comments, I think the risks continue to be on the upside in the economy. I think we should not be lulled by this softening at the fringe, as you put it. So I would very strongly support your recommendation, particularly with respect to the asymmetric language. I think that we do have a period in which we can pause and take stock of what's been happening. And particularly with respect to the dollar, I think if we were to initiate additional tightening moves at this time we might get another increase in the dollar, with the danger of a ratcheting upward of rates around the world that would not be appropriate at this time. So I would strongly support your recommendation.

CHAIRMAN GREENSPAN. President Morris.

MR. MORRIS. Mr. Chairman, I agree with Mr. Parry that the Committee is going to have to be taking other moves toward tightening in the not-too-distant future, but the timing is not right for the moment. And I would agree with your position.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I agree with your position too. The only thing I would add to it is that these rates of inflation projected by the Board's staff, as indexed by the fixed-weight deflator, are way too high. So, I wouldn't be completely satisfied with that outlook, although that may be the most it's reasonable to expect. I would go right down the line with you on it.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, I also agree with your recommendation. I would add only one thing to it in terms of the operations of the Desk. If what we're doing would suggest a federal funds rate of, say 8-1/8, I'd certainly be more comfortable with a slightly higher rate than I would with a lower rate.

CHAIRMAN GREENSPAN. Further comments?

MR. GUFFEY. I'll join.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I, too, agree with the prescription you've put on the table. I guess I would be more in the Bob Parry camp in terms of what I think the likely pressure points are going to be in the intermeeting period. If I could, I'd just like to add a quick comment on the point Governor Kelley and Governor Heller made about the dangers of a recession-induced rise in the budget deficit in the intermediate term. That really is pretty ugly in terms of a setting, not just for monetary policy, but more generally. But I think that of the things that could produce that result, one of them clearly is a rise in the inflation rate in the shorter term. If added inflationary pressure does begin to show through more than it has to date, to be certain that is a recession in the making. So if we're really concerned about a recession-induced rise in the budget deficit, that's just double reason why we should be especially sensitive about any further upward movement in the inflation rate.

CHAIRMAN GREENSPAN. I think we're still ahead of the curve. And that's extraordinary, if we can hold that.

MR. BLACK. Except that the fixed-weight did hit 5 percent last quarter.

CHAIRMAN GREENSPAN. Well, I'm a little suspicious of that. Until I disaggregate it, I don't know what to make of it, because all the other price indicators don't capture that number. Further comments? President Hoskins.

MR. HOSKINS. I think if we're serious about the inflation objectives, over time we're going to have to face further tightening. That's what I suspect right now. There's been a flattening in the yield curve; there's been some improvement in commodity prices; and, I think that needs to be recognized. But if I push forward, it looks to me like we've got more to do. I am encouraged by the moderation in the aggregates relative to the past trend that Governors Angell and Heller raised. I'd have a lot more comfort I guess if, when we did see the signs of inflation picking up, we could move aggressively. But, I think, given the sentiment of the Committee, I can certainly accept your recommendation.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I'm in agreement with that proposal.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. I would just express agreement.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Include me in.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. You can include me, too. I just want to mention one other thing that I haven't heard commented about this morning, and that is the risk to the thrift industry. That industry is already very weak, with many institutions on their backs. And a further significant upward movement in interest rates, as the Board staff presentation yesterday showed us, would add significantly to the number of insolvent institutions around. So I think that's just another good reason for sitting tight. Thank you.

CHAIRMAN GREENSPAN. Governor Heller.

MR. HELLER. I agree with your recommendation.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. I agree with the recommendation. I'll just add a response to what Don was saying earlier about the financial markets and some of the caveats that go with it. I think that's right. I think to some extent that the good behavior of financial markets has a lot to do with the credibility that we've established with our actions. And I think that if there are signs of market wavering-- thinking that we are not credible on policy--then it'll show up and that's the time when we should consider further actions. But I think now the signs look good, and we don't want to lose that credibility we've established with the financial markets. I think clearly this is the right type of policy for now.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. I support the recommendation.

CHAIRMAN GREENSPAN. Governor LaWare, you have any comments?

MR. LAWARE. I do, too. No comments.

MR. BOEHNE. Call the roll.

MR. HELLER. Keep us [unintelligible], right?

VICE CHAIRMAN CORRIGAN. Play your cards right, you can set an all-time record here.

MR. KELLEY. That's where we can get a free lunch.

MR. HELLER. The sandwiches aren't made yet.

MR. BLACK. We had doughnuts, I know that.

CHAIRMAN GREENSPAN. Technically, we have produced the following operational paragraph.

MR. BERNARD. The operational paragraph would read: "In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of indications of inflationary pressures, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, somewhat greater reserve restraint would or slightly lesser reserve

restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with growth of M2 and M3 over the period from August through December at annual rates of about 3 and 5 percent, respectively. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 6 to 10 percent."

CHAIRMAN GREENSPAN. Does anyone have any comments on that particular reading? If not, can I have a vote?

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Black	Yes
President Forrestal	Yes
Governor Heller	Yes
President Hoskins	Yes
Governor Johnson	Yes
Governor Kelley	Yes
Governor LaWare	Yes
President Parry	Yes
Governor Seger	Yes

CHAIRMAN GREENSPAN. I'm going to confirm that the next meeting is November 1st and, well, is this a record?

VICE CHAIRMAN CORRIGAN. Frank Morris would know. Can you judge in terms of the time, Frank? I can't remember any better than quarter of 12.

MR. MORRIS. No, that has to be a record. Even with Bill Martin.

MR. GUFFEY. In fact, we've always--

MR. JOHNSON. No matter what.

MR. GUFFEY. No matter what.

CHAIRMAN GREENSPAN. We have a few topics on the agenda for luncheon, which I guess will be around 12:30. Let's recess until 12:30.

MR. HELLER. We'll take it!

END OF MEETING